

Equalization Payments and Fiscal Fairness in the Federal System of Pakistan

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I. INTRODUCTION

The State of Pakistan has had a less than desirable career in fiscal federalism. At independence, Pakistan opted for the federal system of government for state as it was the natural outcome of independence movement.¹ Provincial autonomy had remained the key demand of Pakistan Muslim League during independence movement, the demand that could have been best achieved under federalism.² Fiscal decentralization, in that context, is an almost naturally resulting mechanism of federalism in order to achieve parity amongst the provinces/units of a state. It is especially important for those states that have large population, diversity of culture and most importantly, disparity of wealth.

In the scheme of federalism, decentralization means both legislative as well as fiscal decentralization where the powers to legislate and administer, and the financial resources to carry out those responsibilities are devolved upon the constituent provinces.³ Provincial autonomy is ineffective without this fiscal decentralization as it would naturally cause an imbalance between the assigned responsibilities and fiscal capacity of the provinces to perform those responsibilities. Equalization payments, then is a primary function of fiscal decentralization whereby the payments are transferred to the constituent provinces from federal government to redistribute the collected revenue, so that equitable distribution of wealth may be achieved between the constituting provinces of federation. Equalization payments therefore are essential to ensure fiscal fairness amongst the federating provinces. In fiscal federalism, the fair distribution of resources has a positive correlation with devolution of power and provincial autonomy which ultimately impact the social uplift and economic progress of the state.⁴ The fair fiscal distribution is also a great indicator of the health of federation reflecting the corresponding trust of federating provinces upon each other and their collective endeavours to have a progressive economy.

¹ Rid 2021, p 119

² Id.

³ Maiz, Beyond Institutional Design

⁴ Id.

In the above context, fiscal equalization is a key political issue in many federal countries. Yet, it is mostly delineated as an economic and financial issue rather than a political one. Pakistan, a federal state comprised of diverse provinces, has been grappling with the issue of fiscal fairness since its independence. This paper intends to review the historical evolution and political underpinnings of the fiscal federalism in Pakistan focusing on equalization payments as a key factor for evaluation. While economic context is always central to the study of fiscal federalism and equalization payments, it's political dimensions cannot be overlooked. The distribution of resources and the formulation of fiscal policies in a federal state are, in a large extent, political processes with political overtones and political outcomes.⁵ It is important to analyse the complex interplay of political forces that influence the design and implementation of equalization payments. It is argued that in Pakistan, often, political decisions and motivations of constitutional and extra-constitutional forces, have hindered the effective functioning of this important fiscal mechanism.

The central argument of this paper is that the mechanism of equalization payments in Pakistan have historically struggled to rectify the fiscal disparity between the provinces. Despite their establishment as means to address economic inequalities, these payments have not achieved the desired level of fiscal fairness that in turn, time and again, have reflected poorly on the internal political integrity of the state. The paper would rely on the analysis of historical data, relevant constitutional frameworks, and an assessment of the broader political context in which fiscal federalism operate in Pakistan.

II. THE CONCEPTUAL FRAMEWORK: FISCAL FEDERALISM, DECENTRALIZATION AND DEVOLUTION

Federalism has demonstrated remarkable adaptability as a system of government, evolving significantly over the past century and a half to align with shifts in political science, constitutionalism, and governance.⁶ While not a novel concept, federalism has transitioned from a state-centric approach to a citizen-centric one, with the primary objective of efficiently delivering public services, accommodating diversity, and maintaining national unity.⁷ Presently, over 40 percent of the global population in 28 countries experiences federal governance,⁸ particularly suited for nations with expansive territories or large populations. The trend also indicates a growing preference for federalism in countries undergoing progressive democratization.

⁵ Lecours and Beland 2010, p.569

⁶ Heather Gerken article

⁷ Maiz, Beyond Institutional Design, The political culture of federalism

⁸ Federalism, Stanford Encyclopedia

The diverse global practice of federalism reveals various forms and models, yet a common feature persists: the existence of at least two levels of government, typically a central or national government and a subnational or regional government. The essence of federalism lies in its power-sharing dynamics between these levels,⁹ preventing overreach and despotism while fostering citizen participation. Federalism, viewed as a mutual contract between central and provincial governments, empowers the former to implement agreed-upon policies, allowing the latter autonomy to tailor policies for their citizens, thereby enhancing electoral responsibility.

Most federal systems incorporate a written constitution, some portions of which are beyond the unilateral alteration by the federal government alone.¹⁰ In the political framework of federalism, distinct political entities coexist within a unified system, preserving individual political identity, culture, and honour. This multi-order arrangement grants each government a degree of independence and corresponding responsibilities towards both the state and its citizens, negotiated and bargained for in democratic spirit. The resulting differences in treatment across regions underscore the fiscal dimension of federalism, emphasizing the equitable distribution of resources and responsibilities.¹¹

Within the comprehensive concept of federalism, the financial aspect, referred to as fiscal federalism, plays a crucial role. Fiscal federalism encompasses the distribution of resources and taxation powers between central and provincial governments, involving specialized mechanisms and principles for revenue collection and distribution among government tiers. It also addresses the division of expenditure responsibilities, equalization payments, and the balance between provincial autonomy and fiscal policy coordination. Consequently, fiscal federalism emerges as an integral facet of the broader federalist framework.

Fiscal Federalism, Decentralization and Devolution. The intricate yet pivotal relationship between fiscal federalism and decentralisation lies in the conceptualisation and application of these principles. Fiscal federalism, as a concept, delineates the fiscal dynamics between central and subnational (provincial and local) governments, forming the basis for the ultimate devolution of power. It fosters a sense of popular ownership and aims to deliver direct benefits such as improved efficiency in public services, enhanced quality of government through democratic accountability, and bolstered economic growth.¹² Developed

⁹ Ahmed, 2010 The Endemic Crisis of Federalism in Pakistan. The Lahore Journal of Economics, 15-31.

¹⁰ Anderson 2014,

¹¹ Brosio and Ahmed 2006

¹² Vazquez and McNab, 2003, p 1604

nations pursue fiscal federalism as it enables cost-effective public services, while developing countries see it as a means to reduce inefficient governance, economic instability, and enhance economic growth.¹³

However, realization of devolution and autonomy hinges on effective fiscal decentralisation.¹⁴ Without the necessary fiscal resources devolved to lower tiers of government, any empowerment of these entities becomes futile. In democratic terms, if lower-tier governments are to be accountable to their constituencies for wielded power, they must also receive the corresponding resources to fulfil those responsibilities. Furthermore, fiscal decentralisation shapes financial relationships and decision-making processes by delineating the revenue and spending powers of each government level, thereby promoting equitable resource allocation.

Equalization Payments as Instruments of Fiscal distribution. Equalization payments are pivotal instruments in fiscal distribution, especially in countries marked by significant economic disparities among regions. These payments ensure that all regions, regardless of their fiscal capacity, can deliver reasonably comparable levels of public services. By redistributing revenue from wealthier to less affluent provinces, this process addresses distributive justice by narrowing inter-regional disparities in public service provision.

In federal systems, fiscal distribution occurs at both vertical and horizontal levels.¹⁵ Vertical distribution involves the allocation of financial resources between different government levels, primarily the central/national government and subnational or local entities. Horizontal distribution, conversely, entails equitable resource sharing among subnational entities within a federal system, maintaining a uniform level of public services for all citizens. This fiscal distribution relies on two types of transfers: first, the redistribution of divisible tax pools and second, subsequent grants and loans. Tax transfers facilitate revenue sharing between the centre and provinces (vertically) and among provinces (horizontally), serving as the primary means of achieving equalization across the federation.¹⁶ Grants-in-aid, as fiscal instruments, are utilized by the central government to assist provincial or local governments in addressing positive interprovincial externalities or aligning policies across jurisdictions.¹⁷ Notably, grants-in-aid play a crucial role in equalization, particularly when directed towards impoverished, conflict-ridden, or disaster-affected areas, as exemplified by the case study of Pakistan.¹⁸

¹³ Usama Mustafa, report on fiscal federalism in Pakistan

¹⁴ Oates; Rabbani 2011

¹⁵ Maiz,

¹⁶ Khawaja & Din, 2013

¹⁷ Rodden 2001

¹⁸ PFC Report 2009

III. EVOLUTION OF FISCAL FEDERALISM IN PAKISTAN (1947-1970)

In the federal system of government, the central government provides fiscal equalization payments to the provincial governments to balance their fiscal capacity for delivering public services.¹⁹ This involves the mutual determination of a formula for redistributing the divisible tax pool. The historical roots of this redistribution practice in Pakistan can be traced back to the pre-partition era, but the current federal structure, comprising four provinces, a federal capital territory, and Gilgit-Baltistan as an administrated region,²⁰ has evolved over time. Pakistan's federal structure was initially shaped by colonial rule and structures, and in the post-independence years, the country deviated from a strict federal model.²¹ It was only with the adoption of the third constitution in 1973 that Pakistan formally committed to federalism. Therefore, the federal character of Pakistan was not inherent but influenced by various historical and political factors both before and after its establishment.

The discussion in this and next section is organised into two sections: one focusing on fiscal federalism before 1970 and the other on developments following the enactment of the 1973 constitution. In this vein, the period before 1973 is considered from 1935 instead of 1947. There are two reasons for it. First, in 1935, the Government of India Act was passed which provided India with its federal-most system of government till that date. And second, Pakistan continued to work the Government of India Act 1935 (1935 Act) as its interim constitution²² till 1956 when it passed its first constitution.

The Government of India Act 1935. The Act marked a significant step towards a federal system in British India, though it fell short of embodying true federalism, retaining a centralised colonial spirit. Provinces were administratively categorized into those with Governors and those led by Chief Commissioners, maintaining colonial-era structures. The Act introduced three lists—federal, provincial, and concurrent—comprising 59, 54, and 36 subjects, respectively, to distribute powers between the central and provincial governments. Notably, discretionary powers were vested in Governors, allowing them to act independently of provincial legislatures.

In terms of fiscal policies, the British colonial government adhered to a highly centralised approach,²³ collecting taxes nationwide and distributing funds unevenly, primarily focused on maintaining control and

¹⁹ Evaluating the efficiency, David Albouy, p 1 (fiscal federalism).

²⁰ Constitution of Pakistan

²¹ One unit reference.

²² Through Independence Act of 1947

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economic stability rather than addressing regional disparities.²⁴ The 1935 Act brought about substantial fiscal changes, particularly through the Niemeyer Award. This arrangement mandated that the federal government share 50% of the collected tax revenue with the provinces, altering the fiscal landscape significantly. Provinces were also granted allocated revenue sources, although with the stipulation that the federal government could reclaim funds as needed. Additionally, provinces were permitted to retain and utilize the revenue generated from sales tax. In essence, while the 1935 Act laid the groundwork for federal principles, it perpetuated colonial centralisation, leaving a lasting impact on governance structures and fiscal policies. These historical dynamics continued to influence the early constitutions of Pakistan, embedding elements of central control and unequal fiscal distribution.

Niemeyer Award 1936. In the context of provincial reforms under the 1935 Act, the Niemeyer Award played a crucial role in the limited devolution of power to the provinces, introducing a distribution formula for collected revenue. However, the award sparked controversy due to its heavily centralised nature, allowing the central government to retain control over the imposition and collection of income taxes. The horizontal distribution among provinces was determined based on population, revenue-generating capacity, and expenditure needs. Despite its significance as the first framework for dividing financial resources between the central and provincial governments, many provinces felt deprived of their fair share, leading to dissatisfaction. The Niemeyer Award remained in force for over a decade and became a notable fiscal legacy for the newly-formed state of Pakistan.

National Finance Conference, November 1947. Along with the federal system of government under the 1935 Act, Pakistan also inherited the fiscal redistribution scheme of the Niemeyer Award from British India.²⁵ However, facing resource constraints in 1947, Pakistan revised the formula to centralize revenue collection further. This involved removing sales tax from the divisible pool and reducing the provinces' share in income tax. East Pakistan experienced a significant setback as its share of jute export duty plummeted from 50% to 37.5%, leading to economic hardships and political tensions with the federal government and Punjab. This revised distribution formula persisted until 1951 when it was replaced by the Raisman Award Programme.

The Raisman Programme. Amidst a lack of political consensus on the constitution and escalating unrest regarding fiscal distribution, the government was compelled to renegotiate the equalization payments

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²⁵ Ahmed et al. 2007

scheme,²⁶ leading to the replacement of Niemeyer awards with the Raisman Award in 1952. The Raisman Award suggested that revenue-generating resources, such as income tax, customs duties, and sales tax, be retained by the central government, while the provincial governments would receive land tax and sales tax on locally produced goods. Equalization payments from the central government to the provinces were recommended to meet their financial needs.²⁷ This arrangement persisted until the National Finance Commission replaced it in the 1973 Constitution of Pakistan. During the Raisman Award period, Pakistan underwent constitutional changes, including the consolidation of West Pakistan into a single unit, reflecting a move toward centralisation rather than decentralisation and provincial autonomy. Despite three financial awards in 1961, 1964, and 1970 under the Raisman Award, the outcomes remained inconclusive due to unusual circumstances.

Fiscal Federalism in 1956 and 1962's Constitutions. The pre-1973 era in Pakistan witnessed the enactment and dissolution of two pivotal constitutions, in 1956 and 1962, each shaping the country's political and fiscal landscape. The 1956 Constitution aimed to establish a federal system of government, granting provinces legislative powers over various functions. However, a critical flaw was the retention of a unitary structure for West Pakistan under the notorious one-unit scheme. This amalgamated smaller regions into a single unit, fostering a highly centralised system that disregarded the diversity and specific needs of different regions. Consequently, the objectives of federalism, decentralisation, and devolution of power were compromised, fuelling a sense of deprivation among the smaller regions that were previously autonomous provinces. The one-unit scheme sowed the seeds of discord in the emerging federation, as it was perceived as a strategic move to counterbalance the population majority of East Pakistan.²⁸

Fiscally, the 1956 Constitution mirrored the 1935 Act, with the federal government retaining the lion's share of tax collection. Provinces, however, were granted income from specific taxes on land, buildings, mineral rights, vehicles, and luxury items. A notable fiscal development was the establishment of the National Finance Commission, tasked with making recommendations for the allocation of federally allocated revenues to provinces. Unfortunately, during the two years the 1956 Constitution was in force, this commission was not instituted. Another provision included the creation of an Inter Provincial Council to enhance intergovernmental cooperation between the centre and provinces and among provinces. However, this council failed to materialize before the constitution's abolition in 1958 when the first martial law was imposed.

²⁶ Refer to Historical Evolution article

²⁷ Id.

²⁸ Shahab 2018, p. 361

The 1962 Constitution marked a new phase, simplifying legislative subjects into a federal list and a concurrent list. Residuary powers were vested in the provinces, ostensibly granting them more autonomy. However, the constitution established the National Finance Commission,²⁹ and the National Economic Council,³⁰ without explicit representation for the provinces, consolidating fiscal policy decisions at the central level.³¹

Between 1961 and 1970, two financial awards were issued under the Raisman Programme – one in 1961 and another in 1964. The 1961 award divided federal revenue between West and East Pakistan in a 54:46 ratio, with provinces also receiving a portion of sales tax and 100% export duty on jute and cotton. The 1964 award maintained the horizontal distribution formula but altered the vertical distribution by reducing the provincially receivable export duty on jute and cotton to 65%. This change disproportionately affected East Pakistan, which was a major producer of these commodities.

In 1970, the 1962 constitution was dissolved, and the one-unit scheme was disbanded. A National Finance Committee was established, announcing a new financial award in which 80% of all export duties and 100% of import duties were shared with the provinces. Unfortunately, the ramifications of previous fiscal decisions manifested in bitter political outcomes, as East Pakistan separated in 1971.

Discussion and Analysis: Pakistan's trajectory toward federalism and fiscal decentralisation has been characterized by a meandering path, marked by persistent colonial vestiges in the early decades that maintained centralised powers and resources. The Niemeyer award of 1936, despite its intent for fiscal distribution, introduced a centralised approach that sowed discord between provinces and the central government. Subsequent revisions in the National Finance Conference of 1947 further intensified centralisation, disproportionately affecting East Pakistan.

The relationship dynamics between the central government and provinces have played a pivotal role in shaping fiscal policy. A discernible power struggle hindered the development of an equitable fiscal system, with the central government's sustained centralisation impinging on the fiscal autonomy of provinces. This limitation constrained provinces from effectively addressing the diverse needs of their populations, resulting in mounting frustration and resentment. The consequences of this centralisation extended beyond fiscal matters, contributing significantly to the broader political instability of the state.

²⁹ Article 144 of the Constitution of Islamic Republic of Pakistan.

³⁰ Ibid Art 145.

³¹ Ali, 1994, p.126.

The fiscal awards made during this time-period (1947-1970) are shown in the following table:

Table 1: Preview of Financial Awards in Pakistan from 1951-1970

Financial Award	Year	Government	Nature	Horizontal Distribution Base
Raisman Award	1951	Liaquat Ali Khan	Inconclusive	GNP, Tax Performance
Raisman Program	1961	Gen. Ayub Khan	Inconclusive	GNP, Tax Performance
Raisman Program	1964	Gen. Ayub Khan	Inconclusive	GNP, Tax Performance
Reform Committee Award	1970	Gen. Ayub Khan	Inconclusive	GNP, Tax Performance

Source: (Sabir, 2010)/ National Finance Commission

Analysis of financial awards during this period reveals three salient points. Firstly, all four awards were characterized by inconclusiveness, lacking consensus and failing to provide clear resolutions on financial distribution and equalization payments. Secondly, three of these awards were implemented during the tenure of Gen. Ayub Khan's government, which not only imposed martial law but also disrupted the democratic process, consolidating political and fiscal power in the central government. The controversial nature of Gen. Ayub Khan's presidency required an active accumulation of powers to maintain control.

Thirdly, all four awards utilised GNP and tax performance as the basis for horizontal distribution, neglecting population as a determining factor. The Homoodur Rahman Commission, investigating the causes of East Pakistan's cessation, identified the absence of population considerations in horizontal equalization payments between 1947 and 1970 and the inequitable distribution of resources as an importance reason fuelling the cause of cessation.³² This omission disadvantaged East Pakistan due to its larger population.³³

In essence, from 1951 to 1973, Pakistan persistently reverted to a colonial playbook, failing to commit to federalism in spirit. Fiscal power remained concentrated in the hands of the central government, exacerbating disparities and contributing to the East Pakistan crisis. The military's active political role during Gen. Ayub Khan's era further fuelled political instability. This historical pattern of centralisation

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³³ (Shah 2002; Mustafa 2011).

and neglect of population considerations in fiscal awards underscored the challenges in achieving a balanced and sustainable federal system.

IV. FISCAL FEDERALISM IN PAKISTAN AFTER 1973

The cessation of East Pakistan and challenges of ensuring unity and fiscal equity between the remaining Pakistan set the tone for 1973's Constitution. One major cause for the separation had been East Pakistan's disappointment with the fiscal equalization in the then Pakistan. Through all the inconclusive financial awards from 1951-1970, East Pakistan had not accepted the continuous dejection of population as an indicator of equalization payments formula and retention of export duty on jute and cotton by the central government. Learning from history, the 1973's constitution attempted to make the distribution of political and financial powers between the central and provincial governments more explicit than before.³⁴

Federalism in 1973's Constitution. The 1973 constitution of Pakistan marked a significant improvement over its predecessors from 1956 and 1962, signalling a substantive shift towards federalism and fiscal fairness. The bicameral legislature, featuring proportional representation in the lower house and parity representation in the upper house, replaced the One Unit scheme, reinstating the four provinces and officially declaring Pakistan a federal republic. However, despite these advancements, the constitution maintained a restrictive list of federal subjects and a lengthy concurrent list, granting both provinces and the centre legislative authority with the centre having primacy in case of conflicts. Notably, the establishment of the Council of Common Interests and the National Finance Commission aimed at fostering cooperation between the centre and provinces and addressing mutual concerns and conflicts. Unfortunately, the Council of Common Interests remained largely inactive, with infrequent meetings and minimal impact on federal-provincial relations, primarily due to the central authority's predominant legislative role and lack of incentive for either party to convene sessions.³⁵

National Finance Commission. The National Finance Commission (NFC) is a pivotal institution established under the constitution of Pakistan to facilitate fiscal distribution and equalization payments. Mandated by Article 160 of the constitution, the President of Pakistan is responsible for constituting the NFC, which comprises the federal finance minister as its chairman, provincial finance ministers, and

³⁴ Baxter, Craig. (1974). Constitution Making: The Development of Federalism in Pakistan. *Asian Survey*, 14(12), 1074-1085. Article Retrieved from: <http://www.jstor.org/stable/2643201>

³⁵ PIDE Report, 2010

additional members nominated by the government. The NFC plays a crucial role in devising an equalization payment framework for the distribution of tax revenues, both vertically (between the central and provincial governments) and horizontally (among the provinces). NFC is required to meet regularly 'intervals, not exceeding five years.'³⁶ The Commission operates on the principle of unanimity, requiring all members to reach a unanimous decision for any award. Once a unanimous decision is reached, the NFC recommends the distribution of financial revenues to the President, who then announces the NFC Award. This award outlines the agreed-upon formula for distributing the divisible pool of national revenue first vertically between centre and provinces, and then horizontally between the provinces.³⁷

However, conflicts arise in the constitution's Article 160(3), specifically in clause (d), which grants the President the authority to add additional taxes to the list of divisible pool taxes. The inclusion of other taxes beyond the specified income tax, sales tax, wealth tax, export, and custom duties becomes a focal point of negotiation between the federal and provincial governments.³⁸ This provision adds a layer of complexity to the process, as disagreements and negotiations persist regarding the expansion of the divisible pool and the subsequent impact on fiscal distribution and equalization payments.

National Finance Commission Awards (1973-2009). In the early years of the National Finance Commission (NFC) in Pakistan, its impact on resource distribution was limited, as the central government retained a substantial share of fiscal resources, leaving the provinces dependent on central grants. Despite this, the NFC represented a step forward in fiscal federalism by introducing a systematic approach to resource distribution and incorporating a rule of 'unanimity' in award determination. While this rule sometimes led to deadlocks and inconclusive awards, replacing it with a 'majority vote' could have had detrimental effects on national harmony.³⁹ From 1973 to 2009, only six awards were announced by the NFC, with commissions in 1979, 1985, 2001, and 2006 choosing not to announce new awards and continuing with previous ones. The seventh NFC award, announced in July 2010, marked a conclusive development and will be explored further in the next section. The layout out these six NFC awards has been produced in the following table 2:

³⁶ Art 160 (1) Constitution of the Islamic Republic of Pakistan.

³⁷ Khawaja and Din 2013, p.24

³⁸ Khalid and Hussain 2018, p.46

³⁹ PFF Report 2012

Table 2: Preview of Financial Awards in Pakistan 1974-2000

Year	Award	Government	Nature	Horizontal Distribution Base
1974	First NFC Award	Zulfiqar Ali Bhutto	Conclusive	Population
1979	Second NFC Award	Gen. Zia ul Haq	Inconclusive	Population
1985	Third NFC Award	Gen. Zia ul Haq	Inconclusive	Population
1990	Fourth NFC Award	Nawaz Sharif	Conclusive	Population
1996	Fifth NFC Award	Benazir Bhutto Revised by Caretaker Govt in 1997	Conclusive	Population
2000	Sixth NFC Award	Gen. Pervaiz Musharaf	Inconclusive	Population

Source: (Sabir, 2010)/ National Finance Commission

The equalization payments framework for both horizontal and vertical distribution as decided by the three conclusive awards have been compared in table 3 below:

Table 3: Comparison of Conclusive NFC Awards

Year of NFC Awards	Vertical Distribution (federation: provinces)	Divisible Pool Taxes	Horizontal Distribution Base
1974	20:80	Export duty on cotton, Income and Sale Taxes	Population
1990	20:80	Export duty on cotton, Income and Sale Taxes, Excise duty in tobacco and sugar	Population
1996	62.5:37.5	All FBR Taxes except: excise duty on natural gas; income tax paid out of federal consolidated fund	Population

Source: Report of National Finance Commission 2009

The provincial shares in these above three conclusive awards have been compared in the following table 4:

Table 4: Provincial Share in NFC Awards

Year of NFC Awards	Punjab %	Sindh %	NWFP %	Balochistan %
1974	60.25	22.50	13.39	3.86
1990	57.87	23.29	13.54	5.30
1996	57.88	23.28	13.54	5.30

Source: (Shahab 2018, p 363)

Discussion and Analysis. The 1973 Constitution, while maintaining a restrictive federal legislative list, delegated numerous subjects in the concurrent lists, granting legislative jurisdiction to both provinces and the federal government. This increased the responsibilities of provinces, but the fiscal distribution of resources did not adequately support this. The federal government retained taxation and collection powers, including income tax, sales tax, capital value tax, federal excise, and custom duties.⁴⁰ Provinces contributed only 8% to the total national revenue, while their share in spending was approximately 28%.⁴¹ This imbalance led to the need for NFC awards to address the fiscal distribution. NFC determines the federal government's share in the national revenue pool and the formula for dividing the provincial share of the divisible pool among provinces.⁴² Article 160 of the constitution mandates NFC to determine federal and provincial shares in national revenue, borrowing powers, grants-in-aid, and related matters. The federal government supplements provincial requirements through special transfers like grants-in-aid (block, matching, or conditional), subsidies, financial assistance, or emergency relief funding. At times, fiscal support is provided by federalizing certain provincial functions to relieve provinces of responsibilities.

The first NFC award in 1974, under Zulfikar Ali Bhutto's government, made significant shifts in favour of fiscal fairness and federalism. It revised the vertical distribution of revenue, giving provinces 80% and the federal government 20% of the divisible revenue pool. Additionally, the formula for equalization payments in horizontal distribution was based solely on population. While the 1974 NFC award was conclusive, financial conflicts between provinces persisted. The conclusiveness was more political than fiscal, aiming to demonstrate agreement and solidarity after the separation of East Pakistan. This horizontal distribution based on population benefited Punjab more than other provinces and since Punjab was the

⁴⁰ Sabir 2010

⁴¹ Watts 2005

⁴² Khawaja and Din 2013, p.4

largest electoral base for democratic governments,⁴³ it seems that political governments did not want to disturb their political popularity.

The focus on population as the sole criterion continued until the seventh NFC award in 2010, when a new multifaceted formula replaced it. Population-based unifactored formulas remained a basis for serious conflict during negotiations for all NFC awards. In 1995, during deliberations for the fifth NFC award, Sindh demanded the inclusion of performance in tax collection as a distribution criterion. KPK and Balochistan also insisted on additional factors such as poverty. These objections led to deadlocks in negotiations, and no conclusive award was announced until 2010. In a political context, the exclusive focus on population as a distribution criterion prompts contemplation. Before 1971, East Pakistan had a larger population than West Pakistan, yet from 1947 to 1973, population was deliberately avoided as the criterion for resource distribution, possibly contributing to East Pakistan's separation. One wonders if considering population as a primary factor for resource distribution earlier, as in the 1974 or subsequent NFC awards, could have prevented the separation of East Pakistan.

After 1974, the next conclusive financial award was made during the fourth NFC in 1990, under the administration of Nawaz Sharif. This marked a positive step towards fiscal equity and provincial financial autonomy. The fourth NFC enhanced the revenue collection bases for provinces and, for the first time, bestowed upon them rights over net hydel profit, developmental surcharge on gas, and excise duty on crude oil.⁴⁴ These benefits were channelled to the provinces in the form of direct transfers, elevating their share from 28% to 45% as part of the vertical balance.⁴⁵ This arrangement persisted in the fifth NFC award of 1995, under the government of Benazir Bhutto, which also garnered unanimous support.

In contrast to the performance of NFC under democratic governments, those during military regimes were predominantly inconclusive, failing to achieve national consensus on critical issues of fiscal distribution and equalization payments. During General Zia's military regime, two Commissions were established in 1979 and 1985, respectively, but consensus among commission members was elusive, leading to no award.⁴⁶ President General Musharraf established the Commission in 2000, yet negotiations faltered over both vertical and horizontal distribution formulae. Provinces sought a larger share in the national pool and advocated for revising the horizontal distribution criterion from a population-based unifactored formula to a more inclusive multifaceted formula to address the concerns of smaller provinces.

⁴³ Punjab's share increased from 56.50 percent (1970 Award) to 60.25 percent while the three other provinces suffered, with Sindh suffering the most because population being the sole criterion for distribution.

⁴⁴ Usama Mustafa 2011, p.4

⁴⁵ Khalid and Hussain 2018, p. 46

⁴⁶ Jaffery and Sadaqat 2006

Again, in 2006, during President General Musharraf's tenure, the Commission failed to reach consensus, and instead of an NFC award, a distribution order was issued through a presidential ordinance.⁴⁷

Under NFC, spanning from 1974 to 2009, six financial awards were conferred, with three being conclusive and three inconclusive. Notably, all conclusive awards (in 1974, 1990, and 1995) occurred during democratic governments led by politicians. The three inconclusive awards in 1979, 1985, and 2000, along with the presidential distribution order of 2006, transpired during the military regimes of General Ziaul Haq and General Pervez Musharraf. It is reasonable to infer that democratic governments create a more conducive environment for reaching compromise solutions amidst conflicting interests. In contrast, non-democratic military regimes, often oblivious to the diverse needs of the country's various regions, exhibit rigidity, restrictiveness, and limitations when confronted with conflicting situations. The distribution of financial resources in a federal system of government is inherently a political issue, and political governments are better suited to resolve it.

V. THE SEVENTH NFC AWARD 2010 AND NEW EQUALIZATION PAYMENTS FORMULA

The seventh NFC award of 2010 warrants separate discussion due to the backdrop of the 18th amendment to the constitution of Pakistan. Although the initial 1973 constitution may not have been an ideal framework for federalism objectives, it possessed the potential to fulfil the goals of federalism. The institutional structure it established facilitated an acceptable distribution of powers among the different provinces of the federation. The constitution introduced a bicameral parliament, incorporating both representation and parity principles to address the concerns of smaller provinces.⁴⁸ The legislative lists were streamlined from three (federal, provincial, and concurrent) to two (federal and concurrent). While a restrictive federal legislative list was present, there was no exclusive provincial legislative list; instead, a concurrent list allowed both federal and provincial legislatures to legislate, with federal laws taking precedence in case of conflicts.

Furthermore, the constitution maintained the federal government's dominance in levying taxes, resulting in a vertical imbalance by devolving responsibilities to provinces in the name of provincial autonomy without expanding fiscal powers. It is essential to note that the 1973 constitution has experienced a tumultuous history. Just four years after its enactment, General Zia suspended it following a military takeover. Throughout its existence, the constitution has faced consistent disruptions, suspensions, and abeyances orchestrated by military generals, citing reasons such as security, the economy, and political

⁴⁷ President, under Article 160(6) of the Constitution, made amendments through Ordinance No.1 of 2006 to the Distribution of Revenues and Grant-in-Aid Order of 1997.

⁴⁸ Constitution of 1973, Articles --

corruption. Restoration only occurred when subsequent parliaments were compelled to provide constitutional cover to unlawful military rule through numerous amendments,⁴⁹ thereby distorting the original federal character and balance of institutional powers outlined in the constitution.

18th Constitutional Amendment and Fiscal Federalism. The passage of the 18th amendment in 2010 marked a significant milestone in achieving a national constitutional consensus to restore the 1973 constitution to its original decentralised federation of provinces, as envisioned in 1956 and 1973.⁵⁰ In terms of devolution, the amendment eliminated the concurrent legislative list, thereby divesting the federal government of its powers and responsibilities in planning, industry, social services and welfare, agriculture, and rural development.⁵¹ This led to the abolition of seventeen ministries, including food and agriculture, education, and health. The provinces absorbed the functions of these ministries into their existing departments. In the banking and finance sector, the federal government was no longer able to act as a regulatory authority on provincially owned banks and entities. The provinces were granted the responsibility and power to handle all public services delivered within their borders, including health and education.

Previously, the federal government had the authority to levy sales tax and capital value tax on financial assets. However, with the amendment, the federal government relinquished taxes on immovable property, estate and inheritance taxes, and Zakat and Usher (religious), transferring these tax powers to the provinces. This gave provinces the potential to increase their revenue through capital value taxes on property.⁵² Furthermore, provinces were now allowed to access capital through borrowing from national and international lenders, subject to the approval of the National Economic Council.

The 18th amendment also bolstered two constitutional institutions in favour of provinces: the National Economic Council (NEC) and the Council of Common Interests (CCI). The NEC, mandated to oversee national economic policy, saw an increase in provincial representation from one to two members, tipping the balance in favour of provinces over the federal government. In the constitutional history of Pakistan, such a devolution of power had not occurred before. Given the lack of prior experience, the role of the Council of Common Interests (CCI) was expanded to facilitate the reinforcement of provincial authority, particularly in domains where both provincial and federal governments shared responsibility,

⁴⁹ 8th and 17th constitutional amendments.

⁵⁰ Shah 2012, p.10

⁵¹ Riaz et al. 2020, p.511

⁵² Shah 2012

such as electricity and natural resources. The amendment required the CCI to meet every 90 days to address these collaborative responsibilities.⁵³

Most importantly, the 18th amendment introduced clause 3A to Article 160, stipulating that a province's share in each subsequent NFC award should not be less than its share in the previous award. This provision substantially closed the possibility of any reversal of the fiscal positions assumed by the provinces under the seventh NFC, providing confirmation and fiscal safeguard to smaller provinces regarding their assured share of equalization payments.

Seventh NFC Award 2010. Interestingly, the conclusion of the seventh NFC award coincided with negotiations for the consensus on the 18th amendment. In this confluence, both the award and amendment were driven by the spirit of reconciliation and accommodation. The 18th amendment, prompted by the aftermath of Benazir Bhutto's assassination, led to the Pakistan Peoples' Party assuming government responsibilities and spearheading efforts to garner consensus for both the 18th Amendment and the seventh NFC award. While the award's agreement was reached in December 2009, its formal announcement in July 2010 followed the passage of the 18th amendment in March 2010, marking a momentous event in Pakistan's constitutional history.

The seventh NFC award is regarded as a significant stride towards fiscal fairness for two primary reasons. Firstly, the federal government agreed to cede 10% of its share in the vertical distribution. Secondly, for the first time since 1974, the horizontal distribution base shifted from a unifactored population formula to a multifactored one.

The following table shows the revenue sharing amongst provinces in the seventh NFC award of 2010:

Table 5: Horizontal Distribution Formula under Seventh NFC Award

Factor	Pakistan	Punjab	Sindh	Balochistan	KPK
Population	82	57.36	23.71	5.11	13.82
Poverty	10.3	23.16	23.41	25.61	27.82
Tax Efforts	5	44.0	50.0	1.0	5.0
IDP	2.7	4.32	7.21	81.92	6.52
Total Share	100	51.74	24.55	9.09	14.62

Source: NFC, Ministry of Finance (www.finance.gov.pk)

⁵³ Rasheed and Rashid 2022, p.6

The alteration in the vertical distribution formula elevated the provinces' share in the federal divisible pool from 47.5% to 57.5%. The added resources to the divisible pool encompassed income tax, wealth tax, sales tax, custom duties, and federal excise duties. Revenue collection charges were also reduced from 5% to 1%, and specific grants-in-aid were allocated to the provinces, providing more transparency to the award. This increase in the provincial share aligned with the ongoing political decentralisation through the 18th amendment, reflecting the need for greater resources directed to the provinces for improved public service delivery. The seventh NFC award's major breakthrough lay in adopting a multifaceted formula for horizontal distribution to equalize financial resources. The challenge of horizontal distribution among provinces had been a persistent issue, given the requirement of unanimous decisions in the NFC. The seventh award addressed the demands of Sindh, KPK, and Balochistan, with Punjab conceding. While population remains the predominant factor, accounting for approximately 82%, other factors like poverty, inverse population density, and tax collection and generation efforts are now part of the distribution formula for equalization payments.

The Eighth and Ninth NFCs. The NFC awards are mandated to be issued on a quinquennial basis, and upon the expiration of their term, there should be a subsequent award according to the constitution. Regrettably, due to disruptions in the political process and military interventions, the issuance of a new award often occurs without consensus or, instead of an award, a presidential order of distribution is issued. This order typically mirrors the distribution scheme of the previous award. While constitutionally mandated under Article 160, such a practice is politically unfavourable in terms of federalism.

Following the completion of the seventh NFC award in 2015, the political turmoil in the country prevented the realization of the eighth NFC award. Instead, in June 2015, the president issued a Distribution of Revenues and Grants-in-aid (Amendment) Order. Despite numerous NFC meetings, a new award could not be reached as the provinces failed to agree on a distribution formula. During this period (2013-2018), the Pakistan Muslim League-N (PMLN) held governments in the centre and Punjab, the Pakistan People's Party (PPP) governed Sindh, and the Pakistan Tehreek-e-Insaf (PTI) was in power in KPK. Balochistan, on the other hand, had a coalition government of smaller nationalist parties, further complicating the consensus.

Additionally, the 2017 census, particularly in Karachi, was rejected by Sindh. The census directly impacts resource distribution as population holds an 82% weightage in the horizontal equalization formula. Furthermore, Azad Jammu & Kashmir (AJK) and Gilgit-Baltistan (GB), which were part of the ninth NFC, were no longer included. In 2018, through the 31st amendment, the FATA region became part of KPK.

With this added burden on resources, KPK requested a renegotiation of the distribution formula to allocate a 3% share from the divisible pool of tax revenue to KPK for the ex-FATA region. The major conflict arose between the federal government and the provinces, where the federal government refused to utilize its own resources for these regions (AJK, GB, and FATA). Instead, it pressed provinces to compromise their own shares to accommodate new responsibilities.

Presently, equalization payments are based on the formula decided in the seventh NFC of 2010 through interim presidential orders. The eighth and ninth NFCs remain inconclusive. Both the PMLN government (2013-2018) and the PTI government (2018-2021) were unable to reach an agreement on distribution. The 10th NFC was constituted in 2020 but has yet to reach any consensus.

VI. FISCAL FAIRNESS AND THE POLITICS OF RESOURCE DISTRIBUTION IN PAKISTAN

Most scholarship on this subject look at the resource distribution as economic and financial function of the state. Its' fiscal side, the maths and numbers almost always take over. Relatively fewer researches in Pakistan have been done with an exclusive focus on its political dimension.⁵⁴ One reason for this has been the ultra-complex relationship of political and fiscal dynamics in Pakistan. The political and fiscal institutions are generally considered symmetrical which means either they are both centralized or are both decentralized.⁵⁵ For e.g., the USA is both fiscally and politically decentralized,⁵⁶ whereas China is considered entirely centralized.⁵⁷ Pakistan, contrary to both, is politically decentralized⁵⁸ and fiscally centralized system.⁵⁹ With the 1973's Constitution, the Local Government Act 2001 and 18th Amendment in 2010, the political system is layered in a three-pronged structure with federal, provincial, and local governments, all with their own sets of powers and responsibilities. However, between the 1973's Constitution and the 18th amendment, there has been two military regimes, from 1977 to 1988 and from 1999 to 2008. It goes without saying that fiscal centralization with the façade of political decentralization has always suited military governments in Pakistan. The political decentralization schemes such as basic democracies⁶⁰ or local bodies system or the latest Local Governments Act 2001, all have been introduced in the time of military governments and mostly to cut to size the national and provincial political leadership then delivering grass root democracy to masses.

⁵⁴ Shahab 2018, Khalid & Hussain 2006; Tunio and Nabi 2021; Asad Ali Shah 2003

⁵⁵ Tunio and Nabi 2021, p.2

⁵⁶ Guibert and Lanvin 1984

⁵⁷ Xu 2011

⁵⁸ Cheema et al. 2005

⁵⁹ Tunio and Nabi 2021, p.2

⁶⁰ Created by Ayub Khan in 1960

Unfortunately, however little, the aspiring political decentralization still does not commensurate well with the fiscal centralization where federal government controls not only the distribution of taxes but also the tax bases and collections. Almost all NFC awards reflect the intention of state to retain the revenue resources with federal government. Since independence, the federal government has maintained an absolute control over one major revenue source, the sales tax, which is otherwise generally acknowledged as a provincial level tax⁶¹ and was so awarded to the provinces under the first Neimeyer award in 1936. However, the state temporarily federalized it in 1948 on the pretext of defence requirements and then in 1952 it was permanently annexed as a federally administered and collected tax. During 1990's NFC, an agreement was almost reached whereby federal government agreed to transfer back the sales tax to provinces as per its commitment in 1952 when it was originally federalized. Unfortunately, it could not materialize.⁶²

The long military regimes with ever-increasing defence budgets, public debt servicing, federal government expenditures, subsidies, and deteriorating economy, have now made it a requirement of the state to continue with restrictive fiscal structures.⁶³ In 1996 NFC, due to resource shortfall, debt servicing and defence budget, provinces were made to relinquish their share in favour of federal government by changing federation to provinces ratio into 62.5:37.5 from 20:80 as in fourth NFC award in 1990. This revised vertical distribution naturally left provinces unhappy.

Amidst all this, however, the biggest casualty has been the criminal neglect of the social sectors such as education, environment, health, and public welfare. This has naturally resulted in the economic disparity and a feeling of unfairness between the provinces and centre, and also amongst the provinces. The inequitable sharing had made provinces protest time and again, against the federal government. Then, post 18th amendment, there is this burgeoning sentiment that provinces have been transferred the liabilities and burdens without the means to meet them. As FATA region was merged into the province of KPK in 2018, KPK has demanded an increase in its share of equalization to accommodate additional burden. The federal government on the other hand had been pressing provinces to relinquish their 7% share in the favour of federal government for it to accommodate AJK and GB. This had been one of the reasons for not reaching any consensus in the ninth NFC from 2015-2020.

The province of Balochistan has been continuously, for past many decades showing its dissatisfaction from the entire equalization process. It makes up around 4% of Pakistan's GDP and while it uses only 17%

⁶¹ In India, mirroring our federal structure, the sales tax is a state-level imposition. Likewise, in the United States and other global federal systems, states or provinces, not the federal government, administer and collect this tax.

⁶² Shah 2003

⁶³ For FY 2017-18, federal government has control over 89% tax collections.

of its resources, remaining 83% are consumed by the state.⁶⁴ Initially, the province had conflict with the federal government regarding the royalty that was due on the pretext of its natural resources. This matter only got resolved in the fourth NFC award in 1990. However, besides that from 1974 to 2006, under all NFC awards, there had been no significant increase in its share.⁶⁵

The province of Sindh has more than a few issues upon the distribution of fiscal resources. It has always argued against the adoption of population as unifactored formula for equalization payments since it renders Sindh's revenue collection, especially at Karachi port inconsequential for equalization payments. Besides this, in all NFCs, the province has put forth its demand for the annexation of sales tax back to provinces. Sindh's concern as to population has been somewhat attended to in the seventh NFC award when more factors have been added for the calculation of distribution formula. However, the fact that population still has 82% weightage in the horizontal equalization formula, the problem may not have been entirely solved.

The population as a single factor for distribution (1974-2006) and now as the weightiest factor i.e., 82% in the multifactored distribution scheme of the seventh NFC award, is confusing when reviewed against the equalization formula from 1947-1971. While East Pakistan was the most populous province, all equalization awards from 1947 to 1970 were made with zero consideration to population. No wonder 'unfair distribution of resources'⁶⁶ has been one of the main reasons for the cessation of east Pakistan. On the flip side, this consistent use of population factor since 1974 has caused serious discontent amongst the smaller provinces as it clearly benefits Punjab, now the most populous province of Pakistan. The province of Balochistan has been hit the hardest under this formula because of its low population density. With the lowest share and largest area, the province has always been dependent on the federal governments for the grants to do developmental work in its vast expanses of lands.

Notably, most federal systems of the world do not use population as major criterion for equalization.⁶⁷ It is argued that population as sole or major criterion is least effective standard for the purposes of fiscal equalization.⁶⁸ The population-based equalization payments assume that the expenditure needs of people across the country are equal whereas in reality those needs may vary depending upon the size, resource endowments, population density and level of development. Also, the remote areas with little to no development may have higher than average expenditure needs comparing to those who live in metropolitan cities. Moreover, it is argued that rewarding the population growth by greater share in resources would

⁶⁴ Hashmi and Fatima 2020, p.49

⁶⁵ Id.

⁶⁶ Hamoodur rehman Report as cited by Asad Ali Sha 2003 and Shahab 2018

⁶⁷ PIDE 2012, p.28. Nigeria is the other federal state that still has population as a sole standard for equalization payments. Pakistan, now with 82% allocation to population is next to Nigeria in this category.

⁶⁸ Id at 30.

generate perverse incentives for population control. Same, however is the argument against poverty as the indicator of equalization payments that by rewarding poverty, the provinces will become disinterested in poverty alleviation measures.

Another serious problem relates to population census and its acceptance by all provinces. Sindh has questioned the veracity of last two censuses. The 2016 NFC could not reach consensus because Sindh had refused to accept the 2017 census results which showed them to have 13 million lesser population than their official estimations. Such large variation of population count could have a serious impact on the resource distribution. Similarly, the current 2023 census has also been rejected by Sindh and Balochistan as they alleged federal government to have undercounted their population.⁶⁹ This, of course, would have direct repercussions on the negotiations in the tenth NFC.

The Seventh NFC award has still made a move towards a multifaceted formula to determine equalization payments which is a step in the right direction. However, it may not resolve the issues between the provinces. The persistent feeling of fiscal unfairness is only a symptom of a deeper problem: a multidimensional problem of trust deficit between the stakeholders: trust deficit between the provinces and centre, between the provinces themselves, between the political parties that usually come to power in these provinces and most importantly, between the military establishment and political parties. The politics around fiscal distribution is marred with this trust deficit. The 1996 NFC award is probably the most controversial of all seven NFC awards. It reduced the share of provinces from 80% to 37.5% in vertical distribution. There were such serious allegations against the federal government that it was called ‘a fraud on the provinces’⁷⁰ Interestingly, the government of Benazir Bhutto was sacked in 1996 and a caretaker government was placed and allegedly through ‘novice care-taker finance ministers mostly chose by the President himself’⁷¹ a consensus on reduction was received. It is also alleged that the caretaker government used highly inflated and false projections of future revenues to make provinces agree on the drastic reduction.

The rejection of 2023 census by Sindh and Balochistan is also a reflection of this trust deficit where provinces have reservations on the intention of federal government regarding the computing of population in the tenth NFC.⁷²

This overall problem of trust deficit is a direct outcome of long history of the complaints of fiscal unfairness by the provinces. While consolidating of west Pakistan into one unit in 1954 is commonly viewed as a move to balance out the majority of east Pakistan, it was an equally drastic step in regard to the

⁶⁹ Nizamani 2023

⁷⁰ Shah 2003

⁷¹ Id.

⁷² Dawn and Nation News articles

provinces in west Pakistan. The consolidation was a regressive exercise into centralization. It pushed the people of west Pakistan with their diverse culture, demography and economy into a unitary structure with concentration of fiscal resources into the hands of federal government. Even after disbanding of one unit in 1970, the practice has conceptually continued and can be seen as one of the biggest reasons for maintaining population as a sole criterion for horizontal distribution. As most populous province, Punjab takes the majority of resources and by controlling Punjab the ruling establishment can control the resources and their distribution as well.

The politics around resource distribution may also be examined as a source of political instability in Pakistan, or on the contrary, the political instability can be seen as a reason for this intricate politics around resources. A critical factor contributing to this continuous recurrence of political instability lies in the military establishment and ruling political elite's non-compliance with the constitutional principles and their disregard for the rule of law. This predicament may find its roots in the persistence of the state's colonial legacy. The nature of relationship between the state and social classes in 'post-colonial societies is different from those explained by classical Marxist theory which draws exclusively upon the Western experience'⁷³ whereas in post-colonial societies, the nation-state is imposed top-down by the colonizing bourgeoisie. The structure so formed in the colony is subordinate to another so-called superstructure, "equipped with a powerful military-bureaucratic apparatus and mechanisms of government",⁷⁴ to enable the exercise of absolute authority over masses. Despite detaching from its origins post-independence, these superstructures continue to wield authority, emerging into an overarching or 'an overdeveloped' state posing risks to its underdeveloped and subservient civilian counterparts. It is the natural need of this superstructure to maintain, almost in an imperialist vein, its political and fiscal hegemony. Hence, Pakistan's strictly centralized fiscal structures, and its ragged and unstable political systems, though are the results of the failures, corruption and selfishness of its politicians, civil society, and masses, but may not be entirely so.

VII. CONCLUSION

The system of fiscal federalism in Pakistan has been fraught with challenges since its inception. The historical trajectory of National Finance Commission (NFC) awards reveals a persistent struggle for fiscal fairness, characterized by recurrent deadlocks arising from provincial discord. Economic diversity and conflicting interests have weakened the bargaining power of smaller provinces, fuelling demands for diverse equalization criteria, yet consensus remains elusive. The institutional framework of the NFC grapples with fiscal decentralization challenges, often resulting in interim awards that favour larger

⁷³ Hamza Alavi, *State of Post Colonial Societies*, 1972

⁷⁴ *Id.*

provinces. The prevalent reliance on population as a criterion has been scrutinized, raising concerns about its efficacy and potential adverse incentives. Effectively weaving together historical, economic, and political dimensions, this paper argues that fiscal fairness is a manifestation of broader trust deficits among stakeholders and recurring political instability in the country.